

A new world for high yield investors

Strategies in Focus: **Fixed income**

Over the past few weeks, additional volatility has been introduced in the high yield market. The most recent catalysts have been the high profile closing of a niche credit fund and the OPEC meeting. But other factors are also weighing on investor sentiment and leading to increased pricing pressure, including lingering concerns over global growth, the decision by the US Federal Reserve in December to raise interest rates, and a reduced broker-dealer balance sheet at year-end.

In terms of our outlook for credit, we have seen changes in the US high yield market over the past few months. We now see a more pronounced deterioration in underlying credit fundamentals. Favorable leverage trends have reversed and a slowing global economy is likely to negatively impact earnings growth. We also expect a material uptick in defaults during 2016, predominantly in industries that have felt the effects of persistently low commodity prices.

US high yield: value potential in defensive areas

High yield spreads have widened materially to reflect increased credit risk. We expect defaults to increase in 2016. However, default rates outside the commodity-related industries should remain below the historical averages. While the spreads in US high yield are currently reflecting recessionary levels, the Fed's outlook for moderate growth indicates there is an opportunity in high yield outside the commodity sectors. We believe the defensive areas of high yield offer value and have structured our portfolios to take advantage of general re-pricing across the market.

Against this backdrop, we continue to favor large segments of the US high yield market, based on more attractive spreads and our analysis of the underlying sectors. We also continue to hold material underweights in the energy and metals & mining industries relative to benchmarks. Despite significant spread widening in commodity-related sectors, we prefer reduced exposure at this time based on our negative fundamental outlook for these sectors. At some point, we expect the energy sector will offer significant return potential given that the energy segment currently yields approximately 14.75%.

We are cognizant of the prevailing liquidity risks and prefer to maintain cash balances between 5-10% and an overweight to investment grade credit at this time.

Euro high yield: likely to experience less volatility

We remain positive on euro high yield. The European Central Bank (ECB) remains poised to continue, and potentially expand, stimulus efforts. A significant portion of the euro high yield market, approximately 25%, is accounted for by the banking sector, which should benefit from the ECB's quantitative easing (QE) program. Euro high yield also has minimal exposure to metals & mining (less than 1%) and energy (approximately 5%). As a result, we would expect euro high yield to be less impacted by developments in the commodity markets and potentially experience less volatility in the current environment.

Short duration high yield: less interest rate sensitivity

We also favor short duration high yield given greater clarity on the maturity profile. These portfolios have more limited exposure to commodity sectors and lower interest rate sensitivity with approximately 1.5 years duration.

We acknowledge that market liquidity has decisively declined post financial crisis and we anticipate volatility in spreads over the course of 2016. Despite expectations for an increase, defaults should remain below historical averages for non-commodity oriented segments.

More broadly, the moderate growth and low inflation environment remains supportive of fixed income. While we would not be surprised by more bouts of volatility, credit sectors continue to benefit from the pervasive demand for income in a low rate environment.



John Dugenske is Head of Fixed Income with overall responsibility for the fixed income investment area. His focus is on alpha generation and ensuring we meet client investment objectives. John joined UBS Asset Management in 2009 and has 27 years of industry experience.

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